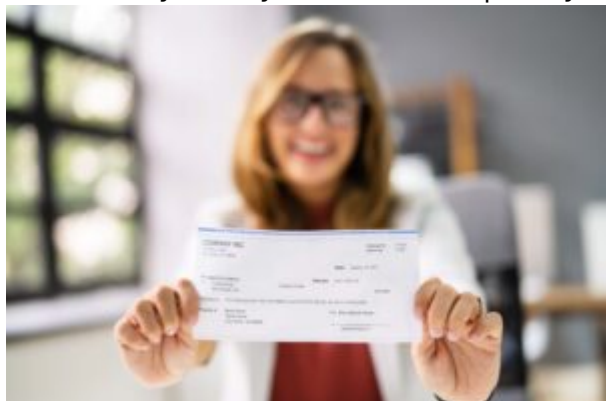


Executive And Director Compensation Trends

written by Haley O'Halloran | July 15, 2024



Amidst high inflation, economic uncertainty, shareholder activism and a continued focus on the executive-to-employee pay disparity, executive compensation continues to attract heightened scrutiny. Boards of directors and senior management teams must carefully balance recruitment and retention considerations with institutional investor pressure, proxy advisory views and public perception to ensure their management teams are well-positioned to act in the long-term best interests of their companies.

Directors increasingly face criticism—and even litigation—from shareholders alleging a breach of directors' duties for what they perceive as excessive executive compensation packages or arrangements that may encourage unwarranted risk-taking behaviour. It is therefore important that board members, and particularly those on the compensation committee, obtain appropriate advice and understand in detail all elements of their organization's executive compensation arrangements.

Overview of executive compensation considerations

- **A growing interest in actual share ownership as opposed to share-based awards.** The Coalition for Good Governance, Glass Lewis, and *Globe & Mail* Board Games methodology recommend encouraging actual share ownership for executives, as opposed to share-based awards that are leveraged or subject to vesting conditions.
- **Incorporating ESG targets into incentive compensation programs.** By folding ESG metrics into incentive compensation programs, companies hope to motivate the executive team to pursue and create greater accountability for the organization's overall ESG strategy.
- **A move away from stock options and performance-based compensation for board members.** Director compensation trends continue to focus on aligning the interests of directors with the long-term interests of the company through a combination of cash and deferred share units.
- **Recent SEC disclosure rules.** Recent SEC rules require companies listed on a U.S. stock exchange to provide a narrative disclosure of their option grant practices. Notably, this requirement does not apply to foreign private issuers. This new requirement may influence views on governance best practices in Canada.

Executive share ownership

Executive share ownership requirements, which are commonly used to align the interests of the management team with those of the company's shareholders, have

received renewed attention from industry watchers. The Canadian Coalition for Good Governance recently made a series of recommendations focused on encouraging actual share ownership for executives as opposed to share-based awards that are leveraged or subject to vesting conditions. Among other things, the report recommends implementing ownership guidelines that do not provide credit for stock options (whether vested or unvested), unvested RSUs or PSUs, or vested awards that are cash-settled with no requirement to reinvest cash proceeds to purchase shares. It also encourages companies to assess share ownership based on either the acquisition cost or the current market value of the underlying securities (and not the higher of the two calculations).

Glass Lewis and *Globe & Mail* Board Games methodology also added new commentary on executive share ownership with similar recommendations for increased actual share ownership in lieu of share-based awards. For CEOs, we are seeing recommendations that share ownership be assessed relative to total direct compensation as opposed to base salary alone. Given that base salary typically represents a relatively small percentage of a CEO's overall compensation, this change may be challenging for some companies to implement in the near term. While some of these recommendations can be addressed through more fulsome disclosure in annual proxy circulars, it would be prudent for companies to revisit their share ownership policies and assess whether a refresh is in order.

ESG in compensation programs

Given the increased focus by boards of directors and investors on ESG matters, many issuers are incorporating ESG targets into their incentive compensation arrangements. These targets may include diversity and inclusion goals, climate-related initiatives, waste and pollution reduction targets, health and safety goals, and programs that reinvest in sustainability and community development initiatives. Incorporating ESG metrics into incentive compensation programs is designed to motivate the executive team to pursue, and create greater accountability for advancing, the overall ESG strategy of the organization. Companies must dedicate sufficient time and resources to effectively develop appropriate targets, audit the company's performance relative to these targets over time, and provide clear and comprehensive public disclosure to shareholders. As companies develop more sophisticated climate change management programs and public reporting, we anticipate seeing more robust climate change targets in executive compensation programs over time.

Director compensation

Director compensation trends continue to focus on paying board members for their time, effort, expertise and responsibility, and on aligning the interests of directors with the long-term interests of the company. Issuers are increasingly moving away from meeting attendance fees, stock option grants and performance-linked compensation for their directors, recognizing that directors should not be paid like executives. Providing directors with a combination of cash and deferred share units, which track the value of the company's shares over time and must be retained until the director steps down from the board, continues to be the preferred director compensation model. Deferred share units provide a mechanism for directors to satisfy their share ownership requirements while ensuring their interests are aligned with those of the shareholders.

U.S. insights

In recent years, the SEC has issued a number of significant rules relating to executive compensation. The recent clawback rules require that all companies listed

on a U.S. stock exchange implement a clawback policy for the recovery of incentive-based compensation of a current or former executive if the company is required to make certain accounting restatements, while the SEC's prescriptive pay-for-performance disclosure rules require companies to clearly demonstrate how management compensation aligns with corporate results. Most recently, the SEC added new rules requiring companies to provide a narrative disclosure of their option grant practices, including the extent to which the company takes into account material non-public information (MNPI), and a quantified, tabular disclosure of stock options or option-like instruments that are granted to named executive officers during the period beginning four business days prior to, and ending one business day after, the filing of a periodic report. For calendar year issuers, this new disclosure requirement will apply to the annual proxy statement filed in 2025 with respect to options granted in 2024. While these SEC disclosure rules do not apply to foreign private issuers and are unlikely to affect most Canadian issuers directly, they may have an influence on institutional investors' and advisory firms' views on governance best practices in Canada.

The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.

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